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C O N F I D E N T I A L SECTION 01 OF 02 BAKU 000205

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SUBJECT: NEW MANAT SLIPS IN THE BACK DOOR AS INFLATION
INCREASES AND MANAT BEGINS SLOW APPRECIATION

REF: BAKU 81

Classified By: Ambassador Reno L. Harnish III, Reasons 1.4(b) and (d).

11. (C) SUMMARY. With the beginning of the new year, the Government of Azerbaijan is facing increasing macroeconomic challenges. The introduction of the newly designed manat and redenomination ultimately went smoothly, although the GOAJ decided to stagger the roll-out of all the notes over several months. Consumer prices, however, have started to creep upwards and on January 6 the government doubled the price of diesel. According to official statistics, the CPI in January increased 1.3 percent, higher than expected. This increase in prices is sure to be a long-term trend despite the National Bank's efforts to keep inflation in check. In addition, the manat has already begun to appreciate further on the local currency market, complicating the work of the National Bank. With the projected government expenditures scheduled to begin in the next two months, the economy may not feel the true effects of the tremendous expenditures until late in 2006, by which time it may be too late to reverse course. END SUMMARY.

THE NEW MANAT ARRIVES WITH A WIMPER

12. (C) The new Azerbaijani manat began circulating officially on January 1, although it took several days for local residents to pocket the new bills and some have yet to use them. In the end, the National Bank announced December 28 that it would introduce only 1 and 5 manat notes (and all six coins) rather than introducing all six bank notes. A National Bank contact has confirmed with EconOff that the National Bank has not yet received the 10, 20, 50 and 100 new manat notes from the printer in Europe. In its December announcement, the National Bank indicated that the 10 and 20 new manat notes will be introduced in March, followed by 50 and 100 new manat notes in April. A National Bank contact confirmed the schedule for the introduction of the 10 and 20 notes, as well as the 50 and 100 notes, although he could not provide a schedule for removing the old manat notes. It is unclear if the National Bank had originally planned this schedule or whether other factors influenced its decision. Many banking contacts told EconOff that the National Bank wanted to introduce the new manat slowly so the local population could "psychologically" get accustomed to the new currency.

13. (C) A senior banking contact at the International Bank of Azerbaijan told EconOff that the National Bank has introduced 30 million new manats into the banking system. The new

manats total only four percent of the total money in circulation. In fact, it can be difficult to find new manats in stores or markets and most Azerbaijanis are using the old manats for daily purchases. According to IBA, the National Bank has not begun removing old manat notes from circulation.

A National Bank executive confirmed to EconOff the amount of new manats introduced into the economy and noted that the National Bank is removing only old, damaged and unusable currency. He added that the National Bank was also continuing to introduce large denominated "old" manat bills.

Azerbaijani Manats or Euros?

¶4. (C) At first glance, the new manats look extremely similar to euros. The new manat bills have a small map of Europe in the bottom left corner that stretches far to include Azerbaijan. Some of the new "qepik" coins are minted with a crescent moon and a five-pointed star on their edges rather than Azerbaijan's eight-pointed star. Also, there is no date minted on the "qepik" coins which has spawned rumors that the government will recall them. A National Bank contact denied the rumors and explained that the star on the coins' edges was a security feature and had nothing to do with the Azerbaijani flag, adding that coins in general did not require a mint date. Most surprisingly of all, former President Heydar Aliyev's image is not on any of the new bank notes; before their unveiling, most Azerbaijanis speculated that the notes would include the late President

JANUARY INFLATION

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¶5. (C) A contact at the National Bank told EconOff that according to official statistics, January 2006 inflation was 1.3 percent, a higher number than expected. (NOTE: According to several banking and economic contacts, inflation in January historically has always been low, with an increase in inflation expected in March, April and May.) The National Bank contact expressed concern to EconOff at the possibility for higher inflation this year, blaming the dangerous spending plans of the GOAJ. He also highlighted the increase in the money supply with new and old manats operating in parallel as an added danger for higher inflation in 2006. The contact noted that the National Bank would work to maintain low inflation but that its tools were limited. In addition, the National Bank understand that its anti-inflationary efforts could lead to an appreciation of the manat and damage the domestic non-oil sector. The IMF reported that price increases in January, especially for food products, may suggest monopolists are using the redenomination and the January 6 diesel price increase (REFTEL) as a smokescreen to catch up on nine months of price restraint.

¶6. (C) COMMENT: The relatively high inflation figure for January, combined with the slow appreciation of the manat, could foreshadow coming macroeconomic problems in 2006. The National Bank is seriously concerned that it will be unable to control inflation and that its efforts, however futile, will hurt the local economy. It is no secret in Baku that the President wants inflation to remain under 10 percent. The GOAJ met this goal last year by "playing" with the CPI numbers. This year, the task will be much more difficult. According to the National Bank, the GOAJ has not yet begun to disperse large amounts of funds previewed in the 2006 budget expenditures. Once this begins, a National Bank official commented, it will take between six and eight months for the full effects of inflation to be realized. By this time, it may be too late for the government to stop spending and the economy could be severely damaged. END COMMENT.
HARNISH